

THE CONTINENTAL ECONOMICS CURRENCY REVIEW

WORLD ECONOMIC OUTLOOK

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Economic growth

The stagnation in Europe continues and the United States is still waiting for a stronger recovery. Monetary policies in Europe, Japan and the US keep interest rates at extremely low levels. In contrast to the US and Japan, the group of European countries which concluded the fiscal pact, will try to practice more restrictive budget policies. This clash of policies will contribute to the turmoil in the months and maybe years to come.

Economic growth in the highly industrialized countries decelerated in 2011 from 3.1 per cent in the final quarter of 2010 to 1.6 per cent in the final quarter of 2011. The same trend took place for the Eurozone where the deceleration was from 2.0 per cent to 0.7 per cent. Germany, which had a relatively strong growth performance by the end of 2010 and early 2011 with a growth rate of 3.8 per cent in the final quarter of 2010 and 4.6 per cent in the first quarter of 2011, slowed down to 2.0 per cent at the end of the year 2011. While the United Kingdom could still managed to keep its growth rate in positive territory in the period from the end of 2010 to the end of 2011 -- with 1.3 per cent in the final quarter of 2010, and 0.8 per cent in the final quarter of 2011-- the Japanese economy had to register negative rates. After ending on the plus side at the final quarter of 2010, quarterly growth rates were all negative for Japan in 2011 with -0.6 in the first quarter of 2011, - 1 per cent in the second, -0.2 in the third quarter and at -0.8 percent at the end of 2011.

Weak economic growth, or, in the case of Japan, negative economic growth, exacerbates the sovereign debt situation. Japan, the country with the highest debt to gross domestic product ratio shows the weakest growth performance. With economic growth rates like those for 2011 it will not only be Japan but also all of the other major industrialized countries that their debt situation will continue to deteriorate to the point of full bankruptcy.

Industrial production weakened even more than gross domestic product in all countries under review. From the first quarter of 2010 to the final quarter of 2011 industrial production deteriorated in the USA from 5.8 per cent to 0.9, in the Eurozone from 8.1 to zero per cent, and in Germany from 13.0 per to 4.2 per cent. In the United Kingdom industrial production turned negative in the second quarter during the year as it was the case with Japan.

It is a futile hope that growth in service could substitute industrial production as a motor of wealth creation. It is the same with consumption. Consumption by itself cannot make the economy grow in the long run. The causality runs the other way: Consumption can expand as much a production will grow.

International trade

In international trade, earlier trends are still in place. The US continues to have a deficit in its current account balance as does the United Kingdom; while Germany, Japan, and China show surpluses. It is notable that while the American and British current account balance worsened over the past year, the surplus of Germany, Japan and China receded. This does suggest that a growing part of the American and British current account deficits is due to imports from non-industrialized countries. The rising

price of oil impacts negatively on the global economy and fills the coffers of the oil-exporting countries. Like it was the case with the oil price spikes before, massive global wealth redistribution takes place. A side effect of this constellation is that the world is drowning in liquidity.

It remains to be seen whether these trends can continue. The current account deficit of the US has become highly persistent. Over the past couple of decades, the US economy has changed its structure from a manufacturing economy to one that has become deeply dependent on services foreign imports. The question remains how long foreign creditors will tolerate this dependency and will continue to finance the persistently high US current account deficits.

In Europe, in the US and in Japan, interest policy has hit zero bound. Interest rates have approached a point where they cannot fall much more. By the end of 2012, the US had an official interest rate of 0.25 per cent per year, while the equivalent rate was one per cent for the euro area, 0.50 for the United Kingdom and 0.10 per cent for Japan. China held its rate steady above six per cent in order to cool its economy.

Interest rate policy in Europe, in the US and in Japan has reached its end point. The expectation held in some quarters that lower interest rates would stimulate investment activity turned out to be a pipe dream. The burden has shifted to fiscal policy, but here too, the results of the stimuli policy have been close to nil.

Monetization of debt through quantitative easing, extremely low interest rates and highly expansive fiscal policies provide an environment that is perfect ingredient for the storm of hyperinflation to come anytime soon.

Currencies

The European debt crisis left its mark on the exchange dollar/euro exchange rate. Over the year 2011 the euro weakened against the dollar from 1.44 to 1.29 dollars per euro. Government interventions have kept the dollar from strengthening more significantly against the Japanese yen and the Chinese currency. Massive interventions, the proclamation of a currency war by the Brazilian government and slower growth of the Brazilian economy, have led to a recovery of the US dollar against the Brazilian currency, the real. While from the last quarter of 2010 to the first quarter of 2011 the US dollar still weakened dramatically against the real from 1.67 to 1.59 at the turn of the year to 2011, the dollar began to strengthen thereafter – much to the relief of the Brazilian government – from 1.59 in the first quarter of 2011 to 1.79 in the final quarter of 2011. This trend has continued in 2012 so far and expectations of appreciations of the US dollar against the Brazilian currency seem justified.

Giving the global uncertainties, the sovereign debt crisis in Europe, the financial crisis in the US and the ongoing weakness of the Japanese economy, it is no surprise that the gold price has kept on rising. From February 2011 until February 2012 the price of gold rose from 1410 dollars per ounce to 1711 US dollar per ounce, a move which made gold one of the better investment of the year 2011. Likewise during this period petroleum was on the rise, with a price increase in this period from 111.8 US dollar per barrel to 127.7 US dollars per barrel.

After their extreme run-up in the past years, the prices for corn, coffee, soya, sugar and grain weakened somewhat in 2011 but compared to the past decades, they are still relatively high and together with the extreme price for oil high commodity prices will surely contribute to inflationary pressures. Up to now it was mainly only the overall weakness of the major industrialized economic areas that loose monetary policy and rising prices for natural resource have not yet led to much higher inflation rates.

Conclusion

Most of the trends that can be observed currently have been in place for some time and most likely will continue so. The longer these trends of rising commodity prices will continue, the more they become incompatible with rising bond and stock prices. One of these two groups must give in. For the first group - gold, oil and commodities - to crash, the emergence of a deflationary depression will be required. This scenario cannot be fully excluded. For the second group - bonds and stocks - to crash, an outbreak of inflation will do. Over the past decades, and particularly in the past couple of years, monetary and fiscal policies of the major economies of the world have provided all that is necessary for hyperinflation to happen. Nevertheless, an outbreak of hyperinflation should not be considered as a certainty. The world economy finds itself in the curious situation that conditions for both, inflation and deflation, have been prepared. The world economy resembles a boat on high sea that has been loaded up with explosives. Either a spark will make the load explode before the boat will sink or the boat will sink on its own and take all that's on board down with it to the ground.

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